interstate-switched transport service between a SWC and an end user's end office. Under the first service, direct-trunked transport, calls are transported between the SWC and the end office by means of a direct trunk, a dedicated facility that does not pass through an intervening switch.[260] The second service, tandem-switched transport, routes calls from the SWC to the end office through a tandem switch located between the SWC and the end office. Traffic travels over a dedicated circuit from the SWC to the tandem switch and then over a shared circuit, which carries the calls of many different IXCs, from the tandem switch to the incumbent LEC end office.[261] Incumbent LEC tandem switches and end office switches switch interstate traffic between the transport trunks carrying traffic to and from the IXC POPs and the end users' local loops.

132. Under the original price cap plan, interstate access services were grouped into four different baskets: the common line, traffic sensitive, special access, and interexchange baskets.[262] In the *Second Transport Order*, the Commission removed transport services from the traffic sensitive basket and combined these services with special access services in the newly created trunking basket.[263] Each basket is subject to a price cap index (PCI), which caps the total charges a LEC may impose for interstate access services in that basket.[264] The PCI is adjusted annually by a measure of inflation minus a "productivity factor," or "X-factor."[265] A separate adjustment

[260] *See* 47 C.F.R. § 69.112 (requiring LECs to impose a flat-rated charge on IXCs to recover the costs of direct-trunked transport).

[261] *See* 47 C.F.R. § 69.111 (prescribing a three-part rate structure for LEC recovery from IXCs of tandem-switched transport costs: a flat-rated charge for the dedicated facility from the LEC SWC to the tandem switch, a per-minute tandem switching charge, and a per-minute charge for common transport from the tandem switch to the LEC end office).

[262] *LEC Price Cap Order*, 5 FCC Rcd at 6788. Originally, interexchange services were to be included in the basket containing special access offerings, however, the Commission concluded that combining these services into one basket "raised issues concerning the flow-through of exogenous costs that can be solved by separating the interexchange activity from interstate access." *Id.* Accordingly, the Commission created the interexchange basket for those LECs that offer interexchange services. *Id.*

[263] Transport Rate Structure and Pricing, CC Docket No. 91-213, Second Report and Order, 9 FCC Rcd 615, 622 (1994) (*Second Transport Order*). Additionally, in the *Access Charge Reform Order*, the Commission determined that, "consistent with principles of cost-causation and economic efficiency, [non-traffic sensitive] NTS costs associated with local switching should be recovered on a flat-rated, rather than usage sensitive, basis. Accordingly, for price-cap LECs, [the Commission] reassign[ed] all line side port costs from the Local Switching rate element to the Common Line rate elements." *Access Charge Reform Order*, 12 FCC Rcd at 16035. *See also* Section IV.A.1 *supra.*

[264] *LEC Price Cap Order*, 5 FCC Rcd at 6788.

[265] *Price Cap Second FNPRM*, 11 FCC Rcd at 863. For a complete discussion of the "X-Factor," *see* Price Cap Performance Review for Local Exchange Carriers, CC Docket No. 94-1, First Report and Order, 10 FCC Rcd 8961, 9005-06 (1995) (*1995 Price Cap Review Order*); *see also 1997 Price Cap Review Order*, 12 FCC Rcd at 16642.

is made to the PCI for "exogenous" cost changes, which are changes outside the carrier's control not otherwise reflected in the price cap formula.[266]

133. In the *First Transport Order*, the Commission restructured interstate transport rates for incumbent LECs.[267] The restructuring created facility-based rates for dedicated transport services based on comparable special access rates as of September 1, 1991, derived per-minute tandem-switched transport transmission rates from those dedicated transport rates, established a tandem switching rate, and established a transport interconnection charge (TIC) that initially recovered the difference between the revenues from the new facility-based rates and the revenues that would have been realized under the preexisting "equal charge rule."[268] The TIC was intended as a transitional measure that initially made the transport rate restructure revenue neutral for incumbent LECs and reduced any harmful interim effects on small IXCs caused by the restructuring of transport rates.[269] The Commission, however, subsequently determined that as a per-minute charge assessed on all switched access minutes, the TIC adversely affected the development of competition in the interstate access market.[270] Therefore, the Commission reassigned several costs included in the TIC and established a mechanism that virtually eliminated the remaining per-minute TIC over a short, but reasonable period, primarily by targeting X-factor reductions to the per-minute TIC.[271]

134. In the *Access Charge Reform Order*, the Commission instituted reforms so that access costs are recovered in a manner that more accurately reflects how they are incurred. Recognizing that a significant portion of local switching costs, (i.e., the costs associated with line cards and trunk ports)[272] do not vary with usage, the Commission required that such non-traffic sensitive costs be recovered on a flat-rated, rather than usage sensitive basis.[273] Because the

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266 *LEC Price Cap Order*, 5 FCC Rcd at 6792, 6807. Exogenous costs are those triggered by administrative, legislative, or judicial action beyond the carriers' control. These costs are created by such events as: the expiration of amortizations; changes in the Uniform System of Accounts; separations changes; changes in universal service fund obligations; the reallocation of regulated and nonregulated costs; tax law changes; retargeting the PCI for price cap carriers taking advantage of the low-end adjustment mechanism; inside wire amortizations; and the completion of amortization of equal access expenses. 47 C.F.R. § 61.45(d)(1).

267 Transport Rate Structure and Pricing, CC Docket No. 91-213, Report and Order, 7 FCC Rcd 7006 (1992) (*First Transport Order*).

268 *First Transport Order*, 7 FCC Rcd at 7009-10, 7029. Under the equal charge rule, which arose from the AT&T divestiture of the BOCs, the BOCs were required to charge a per-minute, distance sensitive rate for their transport offerings, regardless of how the underlying costs were incurred.

269 *First Transport Order*, 7 FCC Rcd at 7038-42.

270 *Access Charge Reform Order*, 12 FCC Rcd at 16073.

271 *Access Charge Reform Order*, 12 FCC Rcd at 16073-86. At present only GTE still retains a per-minute TIC.

272 Line cards connect subscriber lines to the switch, and trunk ports connect interoffice trunks to the switch. *Access Charge Reform Order*, 12 FCC Rcd at 16034.

273 *Access Charge Reform Order*, 12 FCC Rcd at 16034.

record was not adequate, however, to determine whether and to what extent the remaining switching costs were traffic sensitive or non-traffic sensitive, LECs continue to recover these costs through traffic sensitive charges. As part of the *Pricing Flexibility Order*, the Commission invited comment on whether and to what extent it should modify further its price cap rules for the traffic sensitive and trunking baskets to reflect capacity-based local switching and tandem switching rate structures.[274] Also in the *Pricing Flexibility Order*, the Commission proposed adding a "q" factor to the formulas used to adjust annually the PCIs for the baskets that contain the charges for local switching and tandem switching.[275] The q factor would reduce switching charges based on growth in demand.[276] As proposed, the PCIs of the affected baskets would be reduced annually by both the X-factor and the q factor.

b. The X-Factor

(i) Prior Commission Decisions and Pending Proposals

135. The Commission's LEC price cap scheme allows prices to increase by a measure of inflation minus a productivity offset, or X-factor.[277] In the Commission's LEC price cap formula, the X-factor represents the amount by which LECs can be expected to outperform economy-wide productivity gains.[278] The X-factor adopted in the *LEC Price Cap Order* initiating price cap regulation for the largest LECs consisted of a component based on historical LEC productivity, and an additional productivity obligation of 0.5 percent as a consumer productivity dividend (CPD) to assign the first productivity gains to customers in the form of lower rates.[279]

136. Initially, price cap LECs were required to share a portion of their earnings in excess of specified rates of return with their access customers by temporarily reducing the price cap ceiling in a subsequent period.[280] In 1990, the Commission prescribed two X-factors: a

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274 *Pricing Flexibility Order*, 14 FCC Rcd at 14327-33.

275 *Pricing Flexibility Order*, 14 FCC Rcd at 14330-31, 14333.

276 The q factor would operate as a mechanism to allocate revenue between price cap LECs and IXCs, similar to the g factor present in the common line PCI formula. *See Pricing Flexibility Order*, 14 FCC Rcd at 14330-31. The g factor is used to share with IXCs the benefits of demand growth that LECs receive from per-minute growth per access line. *LEC Price Cap Order*, 5 FCC Rcd at 6794.

277 Rules governing price cap LECs are set forth in Part 61 of our rules. 47 C.F.R. Part 61.

278 *LEC Price Cap Order*, 5 FCC Rcd at 6796.

279 *LEC Price Cap Order*, 5 FCC Rcd at 6796.

280 The price cap sharing requirement established three sharing zones determined by specified rate of return levels. In the first "no-sharing zone," price cap LECs were allowed to keep all of their earnings up to the first rate of return ceiling. Above that ceiling, in the "50-50 sharing zone," price cap LECs were entitled to retain 50 percent of their earnings and were required to return 50 percent of their earnings to ratepayers up to the second ceiling. Price cap LECs were required to return 100 percent of any earnings above the "50-50 sharing zone" ceiling to ratepayers. *LEC Price Cap Order*, 5 FCC Rcd at 6801.

minimum 3.3 percent X-factor, and an optional 4.3 percent X-factor.[281] Price cap LECs that opted to use the higher X-factor were allowed to retain larger shares of their earnings. Additionally, the Commission adopted a low-end adjustment mechanism for LECs with earnings below a specified threshold.[282] The *LEC Price Cap Order* required that the Commission periodically review the performance of the price cap regime.[283] The order in the first performance review was released in 1995, at which time the Commission increased the minimum X-factor from 3.3 percent to 4.0 percent, and provided two optional X-factors of 4.7 and 5.3 percent.[284] In the next performance review order, released in 1997, the Commission further revised the price cap plan by eliminating all sharing requirements and prescribing a new X-factor of 6.5 percent.[285] This X-factor prescription relied primarily on a staff study (1997 Staff TFP Study) of the historical rate of growth in LEC total factor productivity (TFP).[286] The Commission also retained the low-end adjustment mechanism for incumbent LECs with earnings below a specified threshold in the *1997 Price Cap Review Order*.[287]

137. In the *Pricing Flexibility Order*, the Commission tentatively concluded that it should measure inflation in the PCI formula with a chain-weighted GDP-PI, which bases weights for the current year's index on the prior year.[288] The Commission reasoned that it should change from the "Fixed Weight Price Index for Gross Domestic Product, 1987 Weights" to a chain-weighted GDP-PI to be consistent with the U.S. Department of Commerce's Bureau of

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281 *LEC Price Cap Order*, 5 FCC Rcd at 6787. These amounts included the CPD.

282 The low-end adjustment mechanism permits incumbent LECs earning rates of return less than 10.25 percent in a given year to increase their PCIs to a level that would allow them to earn 10.25 percent. *LEC Price Cap Order*, 5 FCC Rcd at 6804; *1997 Price Cap Review Order*, 12 FCC Rcd at 16691. In the *Pricing Flexibility Order*, the Commission eliminated the low-end adjustment for price cap LECs that qualify for and elect to exercise either Phase I or Phase II pricing flexibility. *Pricing Flexibility Order*, 14 FCC Rcd at 14304.

283 *LEC Price Cap Order*, 5 FCC Rcd at 6789.

284 *1995 Price Cap Review Order*, 10 FCC Rcd at 9055-56. These amounts included a 0.5 percent CPD. No sharing obligations were imposed on LECs that chose the 5.3 percent option.

285 *1997 Price Cap Review Order*, 12 FCC Rcd at 16645.

286 *1997 Price Cap Review Order*, 12 FCC Rcd at 16645. TFP measurement is a methodology commonly used to measure productivity and productivity growth in the economy as a whole. Productivity is measured as the ratio of an index of the outputs of a firm (or industry, or nation) to an index of its inputs. Productivity growth is measured by changes in this ratio over time. The 1997 Staff TFP Study calculated the historical difference in productivity growth between LECs and the economy nationwide for the period 1986 through 1995. Specifically, it calculated the difference between LEC TFP change and economy-wide TFP change. The study then calculated an input price differential reflecting the difference in the rate of change of LEC input prices as compared with the economy as a whole. These two factors were then added together for each year.

287 *1997 Price Cap Review Order*, 12 FCC Rcd at 16649.

288 *Pricing Flexibility Order*, 14 FCC Rcd at 14338.

Economic Analysis (BEA) inflation measure and with that used in setting the X-factor.[289] The Commission sought comment on its tentative conclusion.[290]

(ii) Court Decision

138. Several entities filed petitions for review of the *1997 Price Cap Review Order* with the U.S. Court of Appeals for the District of Columbia Circuit (D.C. Circuit). In its decision on appeal, the court reversed and remanded for further explanation the Commission's decision to select an X-factor of 6.5 percent, although it affirmed the order against petitioners' remaining challenges.[291] The court rejected the Commission's stated rationales for selecting 6.0 percent as the historical component of the X-factor. In particular, the court rejected the Commission's reasons for placing less weight on the lowest averages of productivity growth used to establish the range of reasonableness of 5.2 to 6.3 percent.[292] The court also found that the Commission failed to explain adequately its reliance on an apparent upward trend in productivity growth for the period 1992-1995 in choosing 6.0 percent from this range, as well as its reliance on AT&T's productivity estimates to extend the range of reasonableness upward.[293] In addition, the court remanded for explanation the Commission's choice of 0.5 percent as a CPD component of the X-factor.[294] The court withheld issuance of its mandate, pending the Commission's reconsideration of the X-factor, through June 30, 2000.[295]

(iii) Resulting Commission Price Cap FNPRM

139. Following the Court's decision in *USTA v. FCC*, the Commission commenced a rulemaking seeking comment on alternative bases for prescribing the X-factor.[296] The *1999 Price Cap FNPRM* was released after CALLS filed its Original Proposal. In the *1999 Price Cap FNPRM*, the Commission noted that adoption of the CALLS Proposal would eliminate the need to adjust the X-factor retrospectively in response to the court's remand, or prescribe an X-factor

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289 Although the *Pricing Flexibility Order* states that the Bureau of Labor Statistics (BLS) measures inflation with a chain-weighted GDP-PI, the inflationary measure is actually created by the BEA. *Pricing Flexibility Order*, 14 FCC Rcd at 14338.

290 *Pricing Flexibility Order*, 14 FCC Rcd at 14338.

291 *USTA v. FCC*, 188 F.3d at 521, 530 (D.C. Cir. 1999).

292 *Id.* at 525-26.

293 *Id.* at 526.

294 *Id.* at 527.

295 *See USTA v. FCC*, Order, No. 97-1469 *et al.* (June 21, 1999); *USTA v. FCC*, Order, No. 97-1469 *et al.* (Apr. 13, 2000).

296 *1999 Price Cap FNPRM*, 14 FCC Rcd at 19718.

on a going-forward basis.[297] In response to the *1999 Price Cap FNPRM*, commenters proposed X-factor amounts ranging from 3.71 percent[298] to 11.2 percent.[299]

c. The CALLS Proposal

140. The X-factor would serve a different function under the CALLS Proposal than in the original price cap plan. Instead of representing an estimate of expected annual productivity gains, the X-factor under the CALLS Proposal would be used to reduce local switching and switched transport rates to specified target rate levels, and to reduce special access rates over a set period of time.[300] The proposal thus transforms the X-factor from a productivity factor into a transitional mechanism that operates to reduce rates at a certain pace, and it would not be linked to a specific measure of productivity.

141. Under the original price cap regime, the X-factor would continue indefinitely, subject to periodic performance reviews. X-factor reductions were applied to each price cap basket on a pro rata basis, except for the period of time during which those reductions were targeted to eliminate the per-minute TIC. The CALLS Proposal would alter both of these principles. First, the CALLS Proposal includes two X-factors: one for switched access services, and a separate X-factor for special access services. After predetermined rates are reached, the switched access X-factor would be adjusted to GDP-PI. The special access X-factor would also eventually be adjusted to GDP-PI on July 1, 2004. Because the price cap formula is adjusted by GDP-PI minus the X-factor, setting the X-factor at GDP-PI would effectively freeze the price caps for the remainder of the term of the CALLS Proposal. Second, under the CALLS Proposal, the switched access X-factor reductions would be targeted to the trunking and traffic-sensitive baskets. This means that total switched access revenues would be used to calculate the size of the X-factor reduction, but the actual reductions would only be made to revenues in the trunking and traffic-sensitive baskets. This would cause rates in the targeted baskets to decrease more rapidly and significantly, while rates in the untargeted baskets to which the X-factor would not be applied would remain largely unchanged.

142. CALLS proposes to target a 6.5 percent X-factor for switched access services to the following rates in this sequence: first to the residual per-minute TIC until that rate is $0.00; then to the information surcharge until that rate is $0.00;[301] and finally to the local switching

297 *1999 Price Cap FNPRM*, 14 FCC Rcd at 19718.

298 *See* USTA Reply, CC Docket No. 94-1 at 13 (Jan. 24, 2000).

299 *See* AT&T Comments, CC Docket No. 94-1 at 12-15, 20 (Jan. 7, 2000) (arguing that the historical component of the X-factor should have been 10.1 percent during the period 1997-2000, and the CPD should have been 1.1 percent during the period 1997-2000 and going forward).

300 *CALLS NPRM*, 14 FCC Rcd at 16984-85; Modified Proposal at §§ 3.2.2 and 3.2.7; Appendix B § 61.45(b)(1).

301 The "information surcharge" is a rate element by which carriers recover the costs of white pages directory expenses. It applies to all interstate access switched minutes of use. *See* Petitions for Waiver Concerning 1985 Annual Access Tariff Filings, Memorandum Opinion and Order, Mimeo No. 5007 (Com. Car. Bur., June 7, 1985).

charge and switched transport charges until the carrier's interstate average traffic sensitive charge equals a specified target rate.[302] CALLS proposes a multi-tier target rate system for interstate average traffic sensitive charges, with a target rate of 0.55 cents for the BOCs and GTE, and a target rate of 0.65 cents for other price cap LECs.[303] A further modification of the CALLS Proposal submitted by CALLS and VALOR Telecommunications Company proposes a third target rate of 0.95 cents for entirely rural price cap LECs.[304]

143. CALLS proposes that where a price cap LEC sells a filing entity or portion of a filing entity to another price cap LEC during the term of the CALLS Proposal, the sold filing entity would retain its pre-existing target rate. Two exceptions to this rule exist. First, if a filing entity sold during the term of the CALLS Proposal is merged with a filing entity with a different target rate, the target rate for the merged filing entity would be a weighted average of the combined target rates. Second, if a binding and executed contract existed for the sale of a filing entity on April 1, 2000, the target rate for the filing entity would be the greater of the applicable target rate of the acquiring company, or the target rate under the previous owner.[305] CALLS proposes that price cap LECs account for the differing target rates of filing entities under contract of sale in their tariff review plans (TRPs). Selling price cap LECs would file TRPs on June 16, 2000 that reflected the target rates of the filing entities after they are acquired by the purchasing price cap LEC.[306]

144. For switching and switched transport services, CALLS proposes to apply an X-factor of 6.5 percent until the interstate average traffic sensitive charge target rate is reached. After carriers with target rates of 0.55 cents or 0.65 cents reach these targets, the annual X-factor for baskets except special access would equal GDP-PI. Setting the X-factor at GDP-PI would effectively freeze the price caps for the services comprising switched access services.[307] For primarily rural carriers electing the 0.95-cent target rate, the 6.5 percent X-factor would continue

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[302] Modified Proposal at § 3.2.2; *CALLS NPRM*, 14 FCC Rcd at 16989-90; Appendix B § 61.45(*i*)(2). The "average traffic sensitive charge" is the sum of the local switching component and the transport component. The local switching component will be calculated by dividing the proposed local switching revenues (end office switch, local switching trunk ports, information surcharge, and STP port) by the base period local switching minutes of use. The transport component will be calculated by dividing the proposed transport revenues (switched direct trunk transport, signaling for switched direct trunk transport, entrance facilities for switched access traffic, tandem switched transport, signaling for tandem switching and TIC) by incumbent LEC-only base period transport minutes of use (including meet-point billing arrangements for jointly-provided interstate access by an incumbent LEC and any other LEC). Appendix B § 61.3(e).

[303] Modified Proposal at §§ 3.1.2 and 3.1.3; *CALLS NPRM*, 14 FCC Rcd at 16985; Appendix B § 61.3(qq).

[304] *See VALOR April 14 Letter*. The 0.95-cent target rate would be available to price cap LECs with a holding company average of less than 19 End User Common Line charge lines per square mile served. Appendix B § 61.3(qq)(2).

[305] *VALOR April 14 Letter*; Appendix B § 61.48(o).

[306] Letter from John T. Nakahata, Counsel to CALLS, to Magalie R. Salas, Secretary, FCC, May 25, 2000.

[307] Modified Proposal at § 3.2; *CALLS NPRM*, 14 FCC Rcd at 16988; Appendix B § 61.45(b)(1)(ii).

to apply after the target rate is reached and would be applied to the common line basket to reduce CCL charges.[308] Upon the earlier of the elimination of the CCL charges or June 30, 2004, the X-factor for the primarily rural carriers would equal inflation.[309] The CALLS Proposal offered contingencies in the case that GDP-PI is greater than 6.5 percent or less than zero after an entity has eliminated its CCL and multi-line business PICC charges. If the GDP-PI is greater than 6.5 percent, the X-factor for common line would equal 6.5 percent and all SLC rates and nominal caps on SLC rates would be increased by the difference between GDP-PI and the X-factor. If GDP-PI is less than zero, the X-factor for common line would be zero.[310]

145. Under the CALLS Proposal, price cap LECs would agree to waive the low-end adjustment to interstate access rates for rates charged during the tariff year beginning on July 1, 2000, but not for subsequent years.[311] CALLS members also would agree not to initiate legal or regulatory action to adjust price cap determined rates for interstate access charges billed for access minutes prior to July 1, 2000.[312]

146. CALLS also proposes that price cap LECs would reduce switched access usage charges by an aggregate amount of $2.1 billion on July 1, 2000.[313] The switched access usage charges to be reduced would include average traffic sensitive charges and CCL charges, but would exclude SLCs and PICCs.[314] The switched access usage charge reductions would be accomplished through: 1) the targeting of the 6.5 percent X-factor to switching and switched transport services until the applicable average traffic sensitive charge rates are reached;[315] 2) reductions in CCL charges through application of $650 million of explicit interstate access universal service support;[316] 3) reductions in CCL charges through application of increased SLCs;[317] and 4) reductions in CCL charges from application of a 6.5 percent X-factor to the common line basket for primarily rural carriers after they reach the average traffic sensitive

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308 *VALOR April 14 Letter*; Appendix B § 61.45(*i*)(4).

309 *VALOR April 14 Letter*; Appendix B § 61.45(b)(1)(iii)(B).

310 Modified Proposal at § 3.2.3; Appendix B § 61.45(b)(1)(iii)(A).

311 Modified Proposal at § 4.4; Appendix B § 61.45(d)(1)(vii).

312 However, payees may accept, and payors may not resist any refunds ordered by the Commission. Modified Proposal at §4.3; *CALLS April 28 Letter*.

313 Modified Proposal at § 3.2.4. The reductions necessary to achieve this amount are calculated under Appendix B § 61.48(*l*).

314 Modified Proposal at § 3.2.4; Appendix B § 61.48(*l*).

315 Modified Proposal at § 3.2; *VALOR April 14 Letter*; Appendix B § 61.48(*l*)(17)(ii)(A).

316 Modified Proposal at §§ 2.1.6; Appendix B § 61.48(*l*)(17)(i)(A) and (B).

317 Modified Proposal at § 2.1.6; Appendix B § 61.48(*l*)(17)(i)(C).

charge rate of 0.95 cents.[318] If these reductions do not total $2.1 billion, price cap LECs will make additional reductions to switched access usage charges to make up the difference. These additional reductions would be calculated as a percentage of the local switching element of the price cap LECs, who could take these reductions against any of the average traffic sensitive charge rate elements.[319] Most price cap LECs would not offset these additional reductions by increasing other rate elements. Two mutually exclusive alternatives, however, are proposed to permit certain carriers to move some of these permitted revenues to the common line basket.[320]

147. The first alternative is available to price cap carriers other than the BOCs and GTE that have at least 20 percent of total holding company lines operated by rural telephone companies. These carriers may elect to redistribute to the common line basket the additional reductions to average traffic sensitive charge rates necessary to yield their proportionate share of the total reduction in switched access usage rates.[321] Eligibility for this option is determined at the holding company level, and the amounts to be shifted to the common line basket are determined at the filing entity level. Specifically, eligible companies' non-rural filing entities may shift the amount of additional reductions that exceed 25 percent of local switching element revenues.[322] The predominantly rural filing entities of the eligible price cap LECs may shift the entire proportionate amount of the additional reductions attributable to those filing entities.[323] To the extent the eligible carrier cannot recover all of these revenues within the filing entity, it may recover these amounts from multi-line business PICC and multi-line business SLC charges of other filing entities within the same holding company, provided that they do not exceed the established caps for these charges.[324] This alternative affects only those rate reductions above and beyond the reductions that result from the operation of the existing price cap rules. Price cap

[318] *VALOR April 14 Letter*; Appendix B § 61.45(b)(1)(iii)(B).

[319] Modified Proposal at § 3.2.4; Appendix B § 61.48(*l*)(18).

[320] Modified Proposal at §§ 3.2.4.1 and 3.2.4.2; Appendix B § 61.48(m).

[321] Modified Proposal at § 3.2.4.1; Appendix B § 61.48(m)(1)(ii).

[322] Non-rural filing entities are those within which more than 50 percent of all lines are operated by telephone companies other than those that as of December 31, 1999 were certified by the holding company as rural. *See Universal Service First Report and Order*, 12 FCC Rcd at 8943-44; Self-Certification as a Rural Telephone Company, Public Notice, 12 FCC Rcd 12093 (1997) (*Rural Certification Public Notice)*. Modified Proposal at § 3.2.4.1(i); Letter from John T. Nakahata, Counsel to CALLS, to Jack Zinman, Legal Counsel, FCC, May 25, 2000 at 3; Appendix B § 61.48(m)(1)(ii)(A).

[323] Predominantly rural filing entities are those with greater than 50 percent of lines operated by telephone companies that as of December 31, 1999 were certified by the holding company as rural. *See Universal Service First Report and Order*, 12 FCC Rcd at 8943-44; *Rural Certification Public Notice*. Modified Proposal at § 3.2.4.1(ii); Letter from John T. Nakahata, Counsel to CALLS, to Jack Zinman, Legal Counsel, FCC, May 25, 2000 at 3; Appendix B § 61.48(m)(1)(ii)(B).

[324] Modified Proposal at § 3.2.4.1; *CALLS April 14 Letter*, Appendix B § 61.48(m)(2)(vii). The redistributed switching revenue will not be included in calculations to determine eligibility for interstate access universal service support. *CALLS April 14 Letter*, Appendix B § 61.48(m)(2)(i).

LECs qualifying for this alternative still will make their normal price cap rate reductions. These carriers also will implement the additional switched access rate reductions called for by the CALLS Proposal. This mechanism will be evaluated in the proposed cost review proceeding to determine whether retaining it is warranted.

148. The second option is available to any price cap company that would have July 1, 2000 price cap reductions at the holding company level greater than the industry-wide total July 1, 2000 price cap reductions.[325] These price cap carriers may elect temporarily to shift to the common line basket the amount of the additional reductions above 25 percent of the local switching element revenues necessary to yield their proportionate share of the total reduction in switched access usage rates on July 1, 2000. These carriers may then recover the amounts as additional components of a multi-line business SLC or PICC within the same filing entity. A 6.5 percent X-factor will be applied to the shifted amounts, even after the carriers reach their interstate average traffic sensitive target rates, until the shifted amounts are eliminated.[326]

149. CALLS also would create a separate special access basket.[327] Under the CALLS Proposal the revenues in the special access basket would not be included in the targeting of the X-factor reductions to the switched access usage charges. Instead, the services in the special access basket would be subject to their own X-factor. The special access X-factor would be set at 3.0 percent in 2000, and would be set at 6.5 percent for each of the next three years. After 2003, there essentially would be a freeze on special access PCIs, as the X-factor would equal GDP-PI.[328]

2. Discussion

150. As discussed above, we are adopting the CALLS Proposal on an interim mandatory basis. Price cap LECs that choose not to be regulated under the CALLS Proposal will have their PCIs set at forward-looking economic costs after the completion of a proceeding to determine those costs. Until the cost proceeding is concluded for those price cap LECs that elect it, the CALLS Proposal price cap rules, as described below, will apply to all price cap LECs.

a. Reductions in Switched Access Usage Charges

151. We adopt the CALLS Proposal as it relates to local switching, trunking, and special access. We believe the proposal is in the public interest because it provides an immediate reduction in switched access rates that will result in lower long-distance charges for consumers, while also simplifying the current price cap access charge regime. Adoption of the CALLS Proposal will result in an immediate $2.1 billion reduction in switched access usage charges. All

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[325] For purposes of this option, July 1, 2000 price cap reductions are as a percentage of base period price cap revenues. Appendix B § 61.48(m)(1)(i).

[326] Modified Proposal at § 3.2.4.2; *CALLS April 14 Letter*, Appendix B §§ 61.48(m)(1)(i) and 61.48(m)(2)(vi).

[327] Modified Proposal at § 3.2.7; Appendix B §§ 61.42(d)(5), 61.42(e)(3), and 61.48(n).

[328] Modified Proposal at § 3.2.7; Appendix B § 61.45(b)(1)(iv).

price cap LECs will make the CALLS Proposal's switched access usage charge reductions on July 1, 2000. Upon completion of the required cost proceeding, price cap LECs that choose not to be regulated under the CALLS Proposal will be subject to a true-up of their rates under the CALLS Proposal and of those based on forward-looking economic cost.

152. The CALLS IXCs have committed to pass the reduction to switched access usage charges on to residential and business long-distance consumers,[329] and, except in very limited circumstances, price cap LECs will not recover any of these reductions through non-traffic sensitive flat-rated end-user fees. This means that, contrary to CALLS opponents' concerns,[330] LECs generally will not subsidize the rates they charge high-volume users with revenue they receive from an end-user fee applied to everyone, including low-volume users.

153. Although most price cap LECs would achieve the switched access usage charge reduction solely through rate decreases, CALLS proposed two mutually exclusive alternatives to permit certain carriers to shift some of these charges to limited elements of the common line basket as described below. We adopt these limited exceptions for smaller rural carriers, and for carriers that would have initial reductions above the average of all price cap carriers.

154. Under the first alternative established by these rules, price cap carriers other than the BOCs and GTE that have at least 20 percent of total holding company lines operated by rural telephone companies may elect to shift to the common line basket the switched access usage charges necessary to yield those filing entities' proportionate share of the total reduction in switched access usage rates.[331] As noted above, this mechanism will be evaluated in the proposed cost review proceeding to determine whether retaining this exception or transferring the additional switched access reduction amounts to the common line basket is warranted.

155. Citizens and Global Crossing comment that this option is not an effective solution for smaller rural price cap LECs because the shifted amounts would be recovered from multi-line business SLCs and PICCs, thereby increasing rates in their most competitive markets.[332] We note that the shifting mechanism is not mandatory; smaller rural price cap LECs can choose not to recover their additional switched access usage charge reductions from multi-line business SLCs and PICCs. We believe, however, it is in the public interest to allow these carriers some ability to recover the switched access usage charge reductions. As discussed below, we are adopting a higher interstate average traffic sensitive access charge target rate of 0.95 cents for smaller rural carriers. We believe that adoption of the limited revenue shifting exception, with the availability of the higher target rate, will address sufficiently any concerns raised by the immediate switched access usage charge reduction to small rural price cap LECs.

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[329] *See AT&T March 30 Letter*; *Sprint February 25 Letter*.

[330] Intermedia Comments at 7-8; Time Warner Comments at 2; ALTS Reply at 5; Joint Consumer Commenters Reply at 15.

[331] Modified Proposal at § 3.2.4.1; Appendix B § 61.48(m)(1)(ii).

[332] Citizens Supp. Comments at 9-10; Global Crossing Supp. Comments at 7-8.

156. We also permit any price cap company with reductions per line at the holding company level greater than the industry average to elect temporarily to shift to the common line basket a portion of the amount of the additional reductions to switched access usage charges necessary to yield that carrier's proportionate share of the total reduction in switched access usage rates on July 1, 2000.[333] These shifted amounts will be eliminated through the application of a 6.5 percent X-factor.

157. This transitional exception is reasonable because it permits carriers with above average reductions per line in the first year to spread those reductions more equitably over time while maintaining the $2.1 billion reduction in switched access charges to IXCs on July 1, 2000. Carriers that elect this option can shift a portion of their initial-year reductions to the common line basket and recover these amounts as additional components of a multi-line business SLC or PICC.[334] Although the recovery of the shifted amounts temporarily creates an implicit subsidy, the shifted revenue added to the multi-line business SLC or PICC will eventually be eliminated through application of an X-factor of 6.5 percent beyond the date on which the average traffic sensitive access rates reach the applicable targets.[335]

158. Subject to these two narrowly defined alternatives, price cap LECs will be making significant reductions to switched access usage charges on July 1, 2000 without recovering these reductions through flat-rated end-user charges. We find that these reductions in switched access usage charges have several significant, direct benefits for consumers. First, the IXCs' commitment to eliminate their minimum usage charges in return for this reduction will especially benefit low-volume and moderate long-distance users.[336] Because low-volume and moderate long-distance users make so few calls, such fees have impacted them disproportionately.[337] Second, the reduction in switching charges, when taken with the IXC pass-through commitment, also will result in lower per-minute long-distance rates for all consumers.[338] Finally, the reduction in switched access usage charges will promote competition in the long-distance market between BOC affiliates entering this market and IXCs. To the extent switched access usage charges paid by IXCs are significantly above cost, BOC affiliates would have a competitive advantage because they would obtain switching services from the BOCs at cost. By driving switched access usage charges closer to their actual costs more quickly than would occur under the existing price cap regime, the CALLS Proposal will minimize the competitive advantages

333 The shifted amounts are restricted to reduction amounts that exceed 25 percent of local switching element revenues necessary to yield the carrier's proportionate share of a total $2.1 billion reduction of switched access usage rates on July 1, 2000. Modified Proposal at § 3.2.4.2; *CALLS April 14 Letter*, Appendix B § 61.48(m)(1)(i).

334 *CALLS April 14 Letter*, Appendix B § 61.48(m)(2)(vi).

335 *CALLS April 14 Letter*, Appendix B § 61.48(m)(1)(i).

336 *See AT&T March 30 Letter*; *Sprint February 25 Letter*; CALLS Supp. Comments at 2-4; USTA Supp. Comments at 2. For a full discussion of the IXC commitments, see Section IV.D.3 *infra*.

337 *Low-Volume Long-Distance Users NOI*, 15 FCC Rcd at 6301.

338 *See* Global Crossing Supp. Comments at 12.

BOC affiliates would have over IXCs in offering long-distance services while switched access rates were significantly above cost.[339]

159. Some commenters request that we modify the CALLS Proposal to require that a proportionate share of the additional switched access usage charge reductions agreed upon to reach $2.1 billion in reductions by July 1, 2000 come from tandem-switched rates.[340] Specifically, commenters argue that absent such a requirement, price cap LECs are more likely to decrease rates for direct-trunked transport than tandem-switched transport, thereby competitively disadvantaging smaller IXCs that rely heavily on tandem-switching.[341] We decline to require that a proportionate share of the switched access usage charge reductions come from tandem-switched rates. Our current price cap plan allows price cap LECs flexibility to determine how X-factor reductions should be applied among tandem-switched rates and direct-trunked transport rates. Price cap LECs are free to make that determination on the basis of the relative costs of providing the services and market considerations. The CALLS Proposal does not change that situation and we see no reason to do so. We have previously determined that rules to protect smaller IXCs in competition with large IXCs are unnecessary because the long-distance market is competitive.[342] Therefore, we will not alter our rules to require price cap LECs to take a proportionate share of the $2.1 billion reduction from tandem-switched rates. If price cap LECs do not make any reductions to tandem-switched rates, but target the required additional reductions only to direct-trunked transport, the significant reductions to these rates should make either the purchase of direct-trunked transport or the leasing of transport from larger IXCs an affordable alternative for smaller IXCs.

b. X-Factor

160. During the five-year term of the CALLS Proposal, the X-factor as adopted herein will not be a productivity factor as it has been in past price cap formulas. Instead, the X-factor is now a transitional mechanism to lower access charges to target rates for switched access, and to lower rates for a specified time period for special access. Although the X-factor under the CALLS Proposal will not be tied to price cap LEC productivity, it will lower access charges over the term of the proposal. As noted by CALLS, the prescriptions of prior productivity factors in the price cap formula have been the subject of extensive regulatory proceedings and litigation, and the Commission's decision to select 6.5 percent as the most recent X-factor has been reversed and remanded by the court.[343] The compromise advocated by CALLS will provide a

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[339] *See* MCI Comments at 6; Sprint Supp. Reply Comments at 6.

[340] Cincinnati Bell Supp. Comments at 5-6; Global Crossing Supp. Comments at 11-12; CompTel Supp. Reply at 1-3.

[341] Global Crossing Supp. Comments at 11-12.

[342] *See Pricing Flexibility Order*, 14 FCC Rcd at 14329; *Access Charge Reform Order*, 12 FCC Rcd at 16060.

[343] *See CALLS NPRM*, 14 FCC Rcd at 16983-84; Section IV.B.1.b *supra*.

solution to the contentious X-factor prescription proceeding for the term of the CALLS Proposal for those price cap LECs that do not elect to set rates based on a cost study proceeding.[344]

161. We adopt the CALLS Proposal regarding the targeting of X-factor reductions to switching and switched transport services. Specifically, we will apply the reductions from imposing an X-factor of 6.5 percent to all price cap baskets except special access as indicated above: first to the residual per-minute TIC until that rate is eliminated; then to the information surcharge until that rate is eliminated;[345] and finally to the local switching charge and switched transport charges until the carrier's average traffic sensitive interstate access charge equals a specified target rate. At the current time, only one filing entity in GTE currently retains the TIC, therefore we find that targeting X-factor reductions first to eliminate the minimal remaining TIC serves the public interest.[346] We also find that the elimination of the information surcharge is consistent with the Commission's policy that non-traffic sensitive costs be recovered by a non-traffic sensitive charge.

162. We also adopt target rates of 0.55 cents for the BOC price cap LECs and GTE, 0.95 cents for primarily rural price cap LECs, and 0.65 cents for other price cap LECs.[347] For purposes of applying the 0.95-cent target rate, a primarily rural price cap LEC is one with a holding company average of less than 19 End User Common Line charge lines per square mile served. Target rates for filing entities that are purchased by price cap LECs during the term of the CALLS Proposal will retain the target rate of the selling price cap LEC, subject to the exceptions described above.[348] Rates for price cap LECs that elect to participate in the cost study proceeding in lieu of the CALLS Proposal will be set at forward-looking costs.

163. Once a price cap LEC reaches the applicable target rate level, the X-factor for all baskets except special access will equal GDP-PI. For primarily rural carriers electing the 0.95-cent target rate, X-factor reductions after the target level is reached will be targeted to the

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[344] If a price cap LEC elects to set rates based upon a cost study, the X-factor would be based on LEC productivity.

[345] The information surcharge permits LECs, upon receipt of a waiver from the Commission, to recover costs presently assigned to the information rate element that are intrastate in nature and do not relate to the provision of interstate directory assistance. 47 C.F.R. § 69.109(b). Carriers calculate these costs on a traffic sensitive basis, per minute of access use.

[346] As noted above in Section IV.B.1.A, we established a mechanism to eliminate the TIC in the *Access Charge Reform Order*.

[347] Modified Proposal at §§ 3.1.2 and 3.1.3; *VALOR April 14 Letter*; Appendix B §§ 61.3(qq).

[348] Specifically, target rates for properties that are merged into a filing entity with a different target rate will be a weighted average of the prior and new target rates. The 0.95-cent target rate will be available for all filing entities which were, as of April 1, 2000, under a binding and executed contract for purchase by a primarily rural price cap LEC. *See* para. 143 *supra*; *VALOR April 14 Letter*; Appendix B §§ 61.3(qq)(2) and 61.48(o).

removal of CCL charges in the common line basket.[349] Upon the earlier of the elimination of the CCL charges, or June 30, 2004, the X-factor for primarily rural carriers will equal GDP-PI.

164. CALLS proposes to include revenues and demand from contract tariff services and from UNEs used to provide switched access services in calculating whether the target rates have been reached.[350] We decline to include these amounts in the target rate calculations. In granting price cap LECs flexibility to offer contract-based tariffs, we required the removal of contract tariff offerings from price cap regulation. This removal was to ensure that the individually-tailored contract tariffs do not adversely impact the prices made available to the majority of price cap LEC customers.[351] Including revenue from contract tariffs in the calculation of average traffic sensitive target rates as proposed by CALLS would thwart this goal. Furthermore, we noted in the *Pricing Flexibility Order* that it would be difficult to allocate properly demand for contract tariff offerings that include a package of two or more access services, and declined to adopt a method to do so.[352] Including contract tariff revenues and demand in calculating the CALLS Proposal target rates would require implementing such an allocation method, which we have recently rejected. We have distinguished between UNEs and interstate access charges and have treated them separately under our rules.[353] UNEs are not included in the LEC PCIs. UNEs are irrelevant to carriers using switched access services because UNEs are only a substitute for access services in the special circumstance where the carrier is also providing local service to the end-user customer.[354] Furthermore, even in this circumstance, UNEs and access charges are subject to different pricing standards. The purpose of establishing a target rate is to guarantee a particular rate level for switched access services. Including UNEs may drive access charges above or below the intended target rate, depending upon whether the total element long-run incremental cost (TELRIC) of UNEs is below or above the target rate.

[349] *VALOR April 14 Letter*; Appendix B § 61.45(b)(1)(B).

[350] Modified Proposal at § 3.1.1; Letter from John T. Nakahata, Counsel to CALLS, to Magalie R. Salas, Secretary, FCC, May 17, 2000.

[351] *Pricing Flexibility Order*, 14 FCC Rcd at 14287-88; 47 C.F.R. § 69.727(a)(2)(ii).

[352] *Pricing Flexibility Order*, 14 FCC Rcd at 14305-06.

[353] *See Access Charge Reform Order*, 12 FCC Rcd at 16129.

[354] *See* Implementation of the Local Competition Provisions in the Telecommunications Act of 1996, CC Docket Nos. 96-98, 95-185, Third Order on Reconsideration and Further Notice of Proposed Rulemaking, 12 FCC Rcd 12460, 12483-84 (1997). The Commission is examining the issue of using shared transport for switched access where a competitive LEC is not providing local service in a Further Notice of Proposed Rulemaking. Implementation of the Local Competition Provisions of the Telecommunications Act of 1996, CC Docket No. 96-98, Third Report and Order and Fourth Further Notice of Proposed Rulemaking, 15 FCC Rcd 3696, 3914-15 (1999) (*UNE Remand Order*).

165. Opponents of the CALLS Proposal contend that the proposal eviscerates price cap regulation by eliminating the X-factor adjustment after target rates are reached.[355] According to its opponents, the CALLS Proposal wrongfully assumes that LECs' costs are changing at the rate of inflation and are not affected by productivity gains.[356] As such, the opponents assert, LECs will be allowed to avoid about $1 billion in access reductions in the later years of the proposal.[357] Some opponents suggest that the X-factor should continue to apply to all baskets, even after the target rate is achieved.[358] Under this approach, end-user rates would decline over time through the application of the X-factor and switched access rates would continue to fall even after the target rate was achieved.

166. We reject these contentions in the overall context of the CALLS Proposal. First, switched access usage charges will be reduced immediately by $2.1 billion on July 1, 2000. The reductions in or elimination of some charges, such as the residential PICC, and the increases in other charges, such as the SLC, are approximately equal. Thus, there is a net reduction in overall access and universal service charges of approximately $2.1 billion, an amount $700 million greater than the reduction that would have been achieved through application of the X-factor under our current price cap scheme.[359] Second, we believe that increased competition will serve to constrain access rates in the later years of the CALLS Proposal as X-factor reductions are phased out. We believe that market forces, instead of regulatory prescription, should be used to constrain prices whenever possible.[360] As competitors utilizing a range of technologies, including cable, cellular, MMDS and LMDS, continue to enter the local exchange market, we expect that rates will continue to decrease.[361] We also believe that adoption of the CALLS Proposal will encourage competition by removing implicit subsidies in access charges and recovering costs from those services that cause them. Therefore, the significant up-front reductions coupled with increased competition ultimately should result in access charges that are comparable to those that would be achieved under our current price cap system over the five-year term of the CALLS Proposal. Furthermore, after the five-year term we can re-examine the issue to determine whether competition has emerged to constrain rates effectively.

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355 CPI Comments at 2, 5; MCI Comments at 17; ALTS Reply at 6-7; NASUCA Reply at 16-17; Focal Supp. Comments at 13.

356 CPI Comments at 5.

357 MCI Comments at 9.

358 MCI Comments at 17; Focal Supp. Comments at 10-11; NASUCA Supp. Comments at 19.

359 *See* Appendix C, Graph 2.

360 *See UNE Remand Order*, 15 FCC Rcd at 3906 ("[T]he market price should prevail, as opposed to a regulated rate which, at best, is designed to reflect the pricing of a competitive market."); *Pricing Flexibility Order*, 14 FCC Rcd at 14233 (The Commission eliminated limitations in the density zone pricing plan after concluding that "market forces, as opposed to regulation, are more likely to compel LECs to establish efficient prices.")

361 *See* CALLS Reply at 55.

167. We further disagree with commenters who oppose targeting and argue that the X-factor should continue to apply to all baskets equally.[362] The Commission has targeted reductions to certain baskets since it first adopted price caps. Even though the same productivity factor was applied to all service baskets, the Commission specifically targeted certain reductions to the common line basket by including a "g factor" reduction, representing per-minute growth per access line, in the common line PCI formula.[363] We also targeted X-factor reductions to eliminate the per-minute TIC.[364] In addition, similar to the targeting in the CALLS Proposal, we recently sought comment on a proposal to target reductions to the traffic sensitive and trunking PCI formulas. We proposed introducing a q factor, similar to the g factor in the common line PCI, that would share the benefits of growth in local switching and tandem switching demand with IXCs, because IXCs may be responsible in part for the increase in demand, and the increased demand may not lead to a measurable increase in switching costs to the LECs.[365] We find it reasonable and consistent with past Commission practice to target the X-factor reductions to specific baskets. We note that under the CALLS Proposal, an X-factor equal to the GDP-PI, up to 6.5 percent, will be applied to all the baskets once the target rate for average traffic sensitive access charges is reached, and to the special access basket after 2003.[366] Targeting the X-factor reductions to switching and switched transport services will more quickly reduce charges for these services toward cost-based levels than would be possible under the existing price cap methodology.[367]

168. Focal characterizes the CALLS Proposal's targeting mechanism as an "attempt to escape the price cap rules," arguing that CALLS failed to seek a waiver of the Commission's rules.[368] The CALLS Proposal seeks to *amend* the price cap rules, not to *waive* them; because we issued a notice of proposed rulemaking to amend our price cap rules as proposed by CALLS, there is no need for any waiver of these rules.

169. Some commenters argue that the CALLS Proposal's X-factor targeting approach would reduce facilities-based local exchange competition.[369] Specifically, these commenters

[362] ALTS and Time Warner Supp. Comments at 8-11; Focal Supp. Comments at 6-15.

[363] *LEC Price Cap Order*, 5 FCC Rcd at 6787, 6794-95; 47 C.F.R. § 61.45(c).

[364] *See Access Charge Reform Order*, 12 FCC Rcd at 16081; Section IV.B.1.a *supra*.

[365] *Pricing Flexibility Order*, 14 FCC Rcd at 14331, 14333.

[366] *See* Modified Proposal at §§ 3.2, 3.2.3, and 3.2.7; Appendix B §§ 61.45(b)(1)(ii), 61.45(b)(1)(iii)(A), and 61.45(b)(1)(iv).

[367] *See* GTE Supp. Reply at 30-31.

[368] Letter from Richard J. Metzger, Vice President Regulatory and Public Policy, Focal Communications, to Magalie R. Salas, Secretary, FCC, May 8, 2000 at 2 (*Focal May 8 Letter*).

[369] ALTS and Time Warner Supp. Comments at 10; CPI Supp. Comments at 9-10; Allegiance Supp. Reply at 3; Focal Supp. Reply at 2-3.

object to the targeting of reductions to traffic-sensitive rates, which are subject to competition, while rate levels in the less-competitive common line basket are maintained.[370] In response, Sprint contends that the competitive market has not controlled prices in the exchange access market, and that competitive LECs are charging access rates that are significantly higher than the above-cost rates currently charged by incumbent LECs.[371]

170. In addition, we observe that the target rates are not predatory.[372] To engage in predatory practices, a price cap LEC would have to charge rates below its incremental costs to drive out its competitors, and then raise prices to monopoly levels after the competitors have left the market.[373] As evidence that the target rates are not below price cap LECs' incremental costs, we note that interconnection agreements reached through negotiations in the marketplace contain access rates that are below the target rates.[374] In addition, the CALLS signatory LECs have agreed to charge these rates for a sustained period of time, which they would not do if the rates were predatory. Price cap LECs will not be able to increase these prices to monopoly prices; the rates will remain at the target rates until July 1, 2005, at which time the Commission will re-examine them. We find that targeting is appropriate to drive average traffic sensitive charges closer to the cost of providing these services, and that it will not harm efficient competition.

171. Furthermore, we find it reasonable not to target reductions to the common line basket at this time. When price caps were first implemented, initial rates were targeted to produce the same return across all baskets.[375] Currently, however, price cap LECs' basket earnings are significantly higher for traffic-sensitive services than for common line services.[376]

[370] CPI Supp. Comments at 10; Allegiance Supp. Reply at 3; ALTS and Time Warner Supp. Reply at 7; Focal Supp. Reply at 2.

[371] Sprint Supp. Reply at 7.

[372] Although no commenter alleges that the target rates are predatory, Focal argues that adoption of the CALLS Proposal would permit predation by circumventing the PCI and the upper pricing bands. *Focal May 8 Letter* at 2-3. We are not eliminating either the PCI or the upper pricing bands in this Order. PCIs will continue to apply to each price cap basket, and upper pricing bands will continue to apply to service categories and subcategories within the price cap baskets. *See* Appendix B §§ 61.45, and 61.47(e).

[373] *See Price Cap Second FNPRM*, 11 FCC Rcd at 870; Telephone Company-Cable Television Cross-Ownership Rules, Sections 63.54 - 63.58, CC Docket No. 87-266, Memorandum Opinion and Order on Reconsideration and Third Further Notice of Proposed Rulemaking, 10 FCC Rcd 244, 343 (1994).

[374] *See* Cable & Wireless Comments at 4.

[375] *See LEC Price Cap Order*, 5 FCC Rcd at 6814-17.

[376] Based on 1999 ARMIS data, Commission staff calculated approximate rates of return of 85 percent for the traffic-sensitive basket, 20 percent for the trunking basket, and 15 percent for the common line basket. AT&T has also provided estimates based on 1997 data that show rates of return of 45 percent for the switching basket, 15 percent for the trunking basket, and 9 percent for the common line basket. *See* Letter from Bruce K. Cox, Government Affairs Vice President, AT&T, to Magalie R. Salas, Secretary, FCC, CC Docket No. 96-262, Feb. 19, 1999 at 6. *See also* Letter from Pete Sywenki, Director, Sprint, to Magalie R. Salas, Secretary, FCC, May 12, 2000 at 6.

This is consistent with our observation that the current traffic-sensitive rate structure provides price cap LECs with more revenue when demand increases, regardless of whether costs have increased, resulting in higher earnings.[377] Therefore we find it reasonable to target reductions to traffic-sensitive services rather than to common line services.

172. We also adopt the creation of a special access basket with a separate X-factor as proposed by CALLS. The creation of a separate special access basket, with its own X-factor, benefits dedicated or high-volume users through the reduction of special access rates. Separating special access into its own basket, in conjunction with the IXC commitments, also will benefit residential and small business end users. Under our current rules, special access is recovered through the trunking basket. If it were to remain in that basket, price cap LECs could reduce special access rates while increasing rates for the other rate elements in that basket so that the average rate for that basket remains at the target rate. The creation of a separate price cap basket for special access will preclude price cap LECs from funding reductions in special access charges by increasing the rates for switched transport services in other baskets once the target rates are reached.

173. Cincinnati Bell and Global Crossing argue that a separate, smaller X-factor should be applied to them and other mid-size price cap LECs under the CALLS Proposal because these carriers are not able to achieve the same levels of productivity growth as larger price cap LECs.[378] As noted above, however, the X-factor adopted under the CALLS Proposal is not a productivity offset as past X-factors have been, but is instead merely a ramp-down method to reduce traffic sensitive charges to the stated target levels.[379] Therefore, the asserted inability of smaller price cap LECs to match the productivity growth of larger price cap LECs is irrelevant in this proceeding and we decline to adopt a separate X-factor for smaller price cap LECs. In addition, the price cap low-end adjustment remains available as a backstop mechanism for LECs that have earnings below a specified threshold.[380] Finally, we note that the CALLS Proposal recognizes and addresses the disparity in subscriber bases and resources by providing higher target rates for mid-size and rural price cap LECs. We believe the differences of smaller price cap LECs are reasonably accommodated under the CALLS Proposal, therefore we decline to adopt a separate X-factor for smaller price cap LECs.

174. As observed by some commenters, the controversy regarding the current status of the X-factor and the concurrent uncertainty over the resolution of the controversy disrupts

[377] *Pricing Flexibility Order*, 14 FCC Rcd at 14332 (seeking comment on whether to require a one-time downward adjustment to price cap LECs' traffic-sensitive PCIs to correct for the earnings imbalance).

[378] Cincinnati Bell Supp. Comments at 2-4; Global Crossing Supp. Comments at 8-10; Letter from John S. Morabito, Vice President Federal Legislative and Regulatory Affairs, Global Crossing, to Magalie R. Salas, Secretary, FCC, May 11, 2000.

[379] Modified Proposal at § 3.2; Appendix B § 61.45(b)(1).

[380] The low-end adjustment permits incumbent LECs with rates of return less than 10.25 percent to increase their PCIs to a level that would enable them to earn 10.25 percent.

business expectations and future investment decisions of both LECs and new entrants.[381] As referenced above, we recently issued a Notice of Proposed Rulemaking regarding the prescription of the X-factor.[382] Currently, the Commission has before it comments on whether it should prescribe two X-factors to address separately the period July 1, 1997 to June 30, 2000 and the period from July 1, 2000 forward, or a single X-factor to cover the combined periods. The CALLS Proposal resolves the uncertainty of whether to prescribe one or two X-factors and the uncertainty concerning the appropriate level of the X-factor for those price cap LECs that will be regulated under the CALLS Proposal. CALLS signatories have agreed not to initiate legal or regulatory action to adjust price cap determined rates billed for access minutes prior to July 1, 2000, including the period covered by the D.C. Circuit's stay of the mandate in *USTA v. FCC*.[383] Therefore, those entities that have signed on to the CALLS Proposal have agreed to waive any right to recoupment that they might be entitled to seek if we were unable to justify the 6.5 percent X-factor remanded by the court.

175. We note that not all affected price cap LECs had voluntarily agreed to this term of the CALLS Proposal. The issue of whether recoupment may be warranted for the period covered by the D.C. Circuit's stay of the *USTA v. FCC* mandate is not obviated with respect to price cap LECs that have not voluntarily signed on to the CALLS Proposal. The issue of fashioning remedies, however, is well within our discretion.[384] Available data show that non-signatory price cap LECs have experienced earnings above the prescribed rate of return for interstate access during this period, and thus non-signatory price cap LECs have not been subjected to unreasonably low rates.[385] Because available data do not suggest that specific recoupment is warranted, we do not generally provide for it here. Any non-signatory price cap LEC may, however, seek to show that its access charge rates under the 6.5 percent X-factor were confiscatory, and therefore may seek recoupment of amounts it undercharged during the period of the court's remand.

176. With respect to the interstate average traffic sensitive charge target levels proposed by CALLS, we conclude that the target rates will significantly reduce per-minute access rates, from today's average rate of 1.1 cents per access minute to the target rates of 0.55 cents for the BOC LECs and GTE; 0.95 cents for primarily rural price cap LECs; and 0.65 cents for all other price cap LECs, thereby lowering long-distance bills.[386] We find further that these

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381 GTE Reply at 37-38; Global Crossing Supp. Comments at 5.

382 *1999 Price Cap FNPRM*, 14 FCC Rcd at 19717.

383 *See* Modified Proposal § 4.3; *CALLS April 28 Letter*.

384 *See Public Utilities Comm'n of the State of California v. FERC*, 988 F.2d 154, 163 (D.C. Cir. 1993) ("agency discretion 'is often at its "zenith" when the challenged action relates to the fashioning of remedies.'"); *Natural Gas Clearinghouse v. FERC*, 965 F.2d 1066, 1073 (D.C. Cir. 1992).

385 *See* Interstate Rate of Return Summary for 1999 Based on Initial Reports Filed by Price-Cap Carriers (Apr. 4, 2000). This report showed that the weighted arithmetic mean for all price cap LECs' interstate rate of return was 18.52 percent, up from 16.52 percent for 1998.

386 *See CALLS NPRM*, 14 FCC Rcd at 16984; APT Comments at 7.

target rates are just and reasonable. The target rates are within the range of estimated economic costs of switched access that have been presented to the Commission.[387] In addition, the fact that both purchasers and suppliers of access services, including non-CALLS members, supported the target rates further indicates that they are a reasonable temporary estimate of prices that might be set in a competitive market. In support of the 0.55-cent target rate, MCI commented that adoption of the target rates during the five-year term of the CALLS Proposal will provide an immediate reduction in switched access rates without requiring the completion of a time-consuming review of cost studies.[388]

177. We further conclude that the multi-tier target rate system addresses the reality of a diverse LEC population. We find that the lower target rate of 0.55 cents is reasonable for the larger BOC LECs and GTE due to their economies of scale and broad subscriber bases. We find that a slightly higher target rate of 0.65 cents is reasonable for other LECs that by definition do not have the subscriber bases and resources of the larger BOCs. In addition, we find that a target rate of 0.95 cents for primarily rural price cap LECs is reasonable. Due to the nature of their service areas, primarily rural price cap LECs experience costs that are significantly higher than other price cap LECs of their size, and are unable to spread those costs over a large subscriber base.[389] Therefore, we agree that the higher level is appropriate for primarily rural price cap LECs.

178. Some commenters have argued that the target rates should be lower because, according to state approved interconnection rates, access costs are actually below one half of one cent per minute.[390] The commenters contend that the Commission should reduce access rates to forward-looking costs, like the unbundled network element rates for local transport and termination.[391] The Commission has recognized that, as a legal matter, transport and termination of local traffic are different services than access service for long-distance telecommunications and therefore are regulated differently.[392] As a policy matter, we have determined that a market-

[387] *See* Bell Atlantic/NYNEX Comments, CC Docket No. 96-262 at 22 (Jan. 29, 1997) (cost study supporting traffic sensitive switching costs of approximately one cent a minute); Letter from Joel E. Lubin, Vice President, Federal Government Affairs, AT&T, to Magalie R. Salas, Secretary, FCC, CC Docket No. 96-262 (Feb. 25, 1999) (estimating the economic cost of a switched access minute at $0.00255 for RBOCs and $0.00373 to $0.00544 as a potential proxy for interstate switched access costs); GTE Comments, CC Docket Nos. 96-262, 94-1, 97-250 at 7 (Oct. 26, 1998) (estimating universal service support using a switched access rate of $0.008/minute).

[388] MCI Comments at 4-5.

[389] For example, because VALOR and Citizens have fewer lines per square mile of service area than non-rural price cap LECs, their lines must run farther, and the cost of exchanges is distributed among fewer end users. *See* VALOR Supp. Comments at 3, 7. *See also* Citizens Supp. Comments at 5.

[390] Cable & Wireless Comments at 4; Level 3 Comments at 7; Illinois Commission Reply at 7; NASUCA Reply at 10.

[391] Level 3 Comments at 4-10.

[392] *See Local Competition Order*, 11 FCC Rcd at 16012-13.

based approach, instead of a prescriptive approach in which we set access charge rates at economic cost levels, better serves the public interest.[393] We believe that the target rates we are adopting are a reasonable transitional estimate of rates that might be set through competition. Not only are the target rates supported by both price cap LECs and IXCs, but competitive LECs have also proposed reducing access charges to the same target rates.[394] Reducing the rates to access costs, as the commenters suggest, would necessitate a lengthy and complex proceeding.[395] We believe the public interest is better served by the immediate reduction in access rates brought about by our adoption of the CALLS Proposal target rates. After the five-year term of the CALLS Proposal, we can re-examine the issue to determine whether competition has emerged to effectively constrain rates.

179. Time Warner has argued that the access charge reductions under the CALLS Proposal occur too quickly. Instead, Time Warner urges the Commission to phase-in access charge reform rather than adopting a flash-cut approach.[396] In response, we note that we are adopting a phased-in approach of reducing access charges. Price cap LECs will not reduce access charges to forward-looking cost levels on July 1, 2000, or even by the end of the five-year period, unless they choose to do so by electing not to be regulated under the CALLS Proposal. Instead, we are implementing transitional rates to reduce access charges closer to cost-based rates. We disagree with Time Warner's contention that the access charge reductions made in response to this Order are too steep.[397] Instead we believe that they are a reasonable transitional measure until competition develops sufficiently to enable market forces to determine access charges.

180. As noted above, CALLS has proposed a method for addressing the target rates for filing entities that are being transferred wholly or in part among price cap LECs.[398] We find that this approach avoids rate churn and customer confusion. We also believe addressing these transfers in the June 16, 2000 TRP filings is the most administratively simple way to handle the

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[393] *See Access Charge Reform Order*, 12 FCC Rcd at 16001, 16107 ("Regulation cannot replicate the complex and dynamic ways in which competition will affect the prices, service offerings, and investment decisions of both incumbent LECs and their competitors. A market-based approach to rate regulation should produce, for consumers of telecommunications services, a better combination of prices, choices, and innovation than can be achieved through rate prescription.").

[394] *See* ALTS and Time Warner Supp. Comments at 18; ALTS and Time Warner Supp. Reply at 7. ALTS and Time Warner submitted an alternate plan to the CALLS Proposal that would reduce access charges to the target rates more slowly.

[395] *See* MCI Comments at 4.

[396] Letter from Donald F. Shepheard, Vice President Federal Regulatory Affairs & Policy, Time Warner Telecom, to Magalie R. Salas, Secretary, FCC (May 8, 2000) (*Time Warner May 8 Letter*).

[397] *Time Warner May 8 Letter* at 1.

[398] *See* para. 143 *supra*; Letter from John T. Nakahata, Counsel to CALLS, to Magalie R. Salas, Secretary, FCC, May 25, 2000.

sale of filing entities with different target rates. Therefore, we find that the public interest is served by adopting these requirements.

181. Finally, we adopt the CALLS Proposal's treatment of the low-end adjustment. Price cap LECs cannot claim this adjustment for rates charged during the tariff year beginning July 1, 2000, but will be able to claim this adjustment during the remaining years in which the CALLS Proposal adopted today is effective.[399] Allowing price cap LECs to claim a low-end adjustment in 2000 would complicate the calculation of the $2.1 billion immediate reduction in switched access usage charges called for in the CALLS Proposal. Therefore we are precluding price cap LECs from taking the adjustment in that year. We note, however, that even without the availability of the low-end adjustment mechanism in the first year, price cap LECs are protected by the takings clause of the Constitution from making rate reductions that would be confiscatory. To the extent that price cap LECs can demonstrate that rate reductions under the CALLS Proposal are confiscatory, they may seek recoupment of the confiscatory amounts.

182. We disagree with commenters who argue that the low-end adjustment should not be available to price cap LECs in the remaining years of the CALLS Proposal.[400] We have included the low-end adjustment in our system of LEC price cap regulation to protect LECs from events beyond their control that would affect earnings to an extraordinary degree.[401] Moreover, as noted by commenters, the low-end adjustment is not likely to have a significant practical effect because it has been rarely invoked in the past, and price cap LECs must agree to waive it before taking advantage of pricing flexibility under our rules.[402] We find it reasonable to continue to include this adjustment, to the extent applicable under the CALLS Proposal.

c. Measure of Inflation

183. In implementing the CALLS Proposal, we use GDP-PI as the measure of inflation to which the X-factor will be set once the target levels are reached for switching and switched transport rates, and after 2003 for special access. We take this opportunity to adopt our tentative conclusion in the *Pricing Flexibility Order* to use the BEA chain-weighted GDP-PI to measure inflation in the PCI formula. The BEA changed its measurement of GDP-PI from fixed-weighted indexes, on which our current measure of GDP-PI in the LEC price cap rules is based, to chain-weighted indexes because it found that the chain-weighted indexes are significantly more accurate.[403] CALLS member AT&T agrees, noting in the *Pricing Flexibility Order* proceeding that chain indexes provide the only significant economic comparisons for medium

399 Modified Proposal at § 4.4; Appendix B § 61.45(d)(1)(vii).

400 California Commission Supp. Comments at 8-9; MCI Supp. Comments at 23-27; Ad Hoc Supp. Reply at 14-15.

401 *LEC Price Cap Order*, 5 FCC Rcd at 6804.

402 Bell Atlantic Supp. Reply at 9; Sprint Supp. Reply at 8-9; *Pricing Flexibility Order*, 14 FCC Rcd at 14304-07.

403 *See* J. Steven Landefeld and Robert P. Parker, *BEA's Chain Indexes, Time Series, and Measures of Long-Term Economic Growth*, 77 Surv. of Current Bus. 58 (May 1997).

and longer term periods, while fixed-weight indexes become unrepresentative after only a few years of economic change.[404] Use of the BEA chain-weighted GDP-PI will not affect the aggregate switched access usage charge reductions to be taken on July 1, 2000; however it will make the average traffic sensitive charges reach the target rates slightly faster. The BEA chain-weighted GDP-PI will also result in slightly greater special access charge reductions.

184. Although the change in the measure of GDP-PI was not proposed in the CALLS Proposal, we believe it is in the public interest for the reasons stated above and adopt it in this Order. CALLS has informed us that its proposal was based on the GDP-PI fixed-weight index and changing to a chain-weighted GDP-PI index would materially affect its proposal.[405] We believe instead that this change is merely a technical one that reflects an independent agency's refinement of one of its measurements. As stated above, the chain-weighted index has been found to be more accurate than the fixed-weight index, and is therefore BEA's featured measure of GDP-PI.

C. Universal Service

1. Introduction

185. In the preceding sections of this Order, we have restructured and significantly reduced the interstate access charges imposed by price cap LECs. In this section, based on the CALLS Proposal, we identify a specific amount of access charges as implicit support for universal service, and we establish an explicit interstate access universal service support mechanism to replace such implicit support. In contrast to the Commission's existing high-cost support mechanisms for rural and non-rural carriers, which provide support to enable states to ensure reasonably affordable and comparable *intrastate* rates, the purpose of this federal mechanism is to provide explicit support to replace the implicit universal service support in *interstate* access charges.

186. As explained below, consistent with the principles of the 1996 Act, this interstate access universal service support mechanism proposed by CALLS will provide explicit support that is specific, predictable, and sufficient to ensure that consumers in all regions of the nation have access to telecommunications services at affordable and reasonably comparable rates. Moreover, this support mechanism will provide support that is portable among competing carriers -- if a competitor serves a supported customer, the competitor will receive the interstate access support for that customer. Thus, by adopting the interstate access universal service support mechanism proposed by CALLS, we are able to serve the 1996 Act's dual goals of promoting competition in the telecommunications marketplace and simultaneously preserving and advancing universal service. Specifically, the interstate access universal service support mechanism that we establish today has the following features:

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404 AT&T Reply, CC Docket No. 96-262 at 25 (Nov. 29, 1999), citing F.G. Forsyth and R.F. Fowler, *The Theory and Practice of Chain Price Index Numbers*, 144 J. Stat. Soc'y Am. 224 (1981).

405 *CALLS April 24 Letter*.

- Support is fixed at an annual amount of $650 million.
- Support is explicit, rather than implicit.
- Support is targeted to the density zones that have the greatest need for it.
- Support is provided on a portable, per-line basis.
- Support is available on a competitively neutral basis to any eligible telecommunications carrier serving a supported customer, regardless of the technology used by that carrier.
- Support under the Commission's universal service Lifeline Assistance program for low-income consumers is increased to cover the increase in the residential SLC.

187. In the remainder of this section, we first provide background on universal service principles and Commission actions concerning universal service, followed by an overview of the interstate access universal service support mechanism proposed by CALLS. We then discuss the size of the support mechanism, the distribution of interstate access support, including a discussion of the portability of interstate access support, the changes to our existing Lifeline program, the recovery of universal service contributions by incumbent LECs, and implementation issues for the support mechanism. Finally, we provide a brief summary of our consultations with the Federal-State Joint Board on Universal Service (Joint Board) regarding the issues discussed in this section.

2. Background

188. As previously noted, historically, one of the goals of universal service has been to support the provision of telecommunications service in areas where the cost of providing such service would otherwise be significantly higher than the average cost of providing service in the United States as a whole.[406] This goal has been accomplished by providing support to carriers for both interstate and intrastate services to enable them to serve high-cost consumers at below-cost rates. There are generally three sources of universal service support: (1) state support for basic telephone service;[407] (2) federal support for intrastate costs of local telephone service that

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[406] *See, e.g., Universal Service Ninth Report and Order,* 14 FCC Rcd at 20439.

[407] Some state rate designs have provided implicit high-cost support flowing from (1) urban areas to rural areas; (2) business customers to residential customers; (3) vertical services to basic service; and/or (4) intrastate long distance service to local service. First, many states have adopted the practice of setting uniform local rates throughout the territory that a given company serves within the state, thereby enabling incumbent LECs to charge above-cost rates in urban (low-cost) areas to support the below-cost rates they charge in rural (high-cost) areas. Second, some state regulators have allowed incumbent LECs to charge business customers higher rates than residential customers even though the costs of serving business and residential customers in the same area are roughly the same, thereby creating a business-to-residential support flow. Third, through rate regulation in some states, incumbent LECs are able to charge above-cost rates for vertical services (e.g., touch tone, conference calling, speed dialing, call waiting, caller identification, etc.) in order to support the rates for basic local service. Fourth, incumbent LECs in some states have been able to charge relatively high intrastate access charges to interexchange carriers to cover costs not recovered through local rates. IXCs pass these access charges on to their long distance customers in the form of higher usage charges for intrastate long distance service, thus creating implicit support from long distance service to local service. In addition, some states provide explicit universal service support through direct monetary payments to carriers.

significantly exceed the national average;[408] and (3) federal support for the interstate portion of the local loop and port.[409] In the *Universal Service Ninth Report and Order* and *Universal Service Tenth Report and Order*, we reformed our high-cost support mechanism for non-rural carriers, which provides federal support for *intrastate* costs. In this Order, we reform federal support for the *interstate* portion of the local loop and port.

189. Universal service support has been both explicit and implicit. For example, various federal support mechanisms provide explicit monetary support payments to LECs.[410] LECs have also received implicit support from the Commission's interstate access charge regime, which permitted LECs to recover the interstate cost of the local loop and port in a manner different from the way that cost was incurred. For example, instead of allowing LECs to recover the entire non-traffic-sensitive cost of the local loop and port through a flat-rated charge to the customer, the Commission capped the amount of that charge because of concerns that customers would disconnect their telephone service if the charge were too high.[411] LECs recovered the non-traffic-sensitive costs that exceeded the cap on flat-rated charges through traffic-sensitive (per-minute) charges to IXCs, thus creating an implicit support flow from the IXCs to the LECs' customers. In addition, the LECs' flat-rated charges for business customers were higher than the flat-rated charges for residential customers, even though the costs of serving these different customer classes did not significantly differ. This rate differential created an implicit support flow from business customers to residential customers. Finally, LECs were permitted to average their flat-rated charges over large geographic areas. This geographic averaging created an implicit support flow from low-cost customers to high-cost customers.

190. *Universal Service Principles*. In the 1996 Act, Congress codified the Commission's historical policy of promoting universal service to ensure that consumers in all regions of the nation have access to telecommunications services.[412] Specifically, in section 254 of the Act, Congress instructed the Commission, after consultation with the Joint Board, to establish specific, predictable, and sufficient mechanisms to preserve and advance universal service.[413] Moreover, recognizing the vulnerability of implicit support to competition, Congress

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408 *See, e.g, Universal Service Ninth Report and Order*, 14 FCC Rcd at 20453.

409 *See, e.g, Universal Service Ninth Report and Order*, 14 FCC Rcd at 20451-52 (deferring the issue of identification and removal of implicit support in the interstate access charge system).

410 *See, e.g.*, 47 C.F.R. §§ 54.301 (Local Switching Support), 54.303 (Long Term Support) and 54.309 (Forward-looking high-cost support for non-rural carriers).

411 *Access Charge Reform Order*, 12 FCC Rcd at 15992-93.

412 According to the Joint Explanatory Statement, the purpose of the 1996 Act is "to provide for a pro-competitive, de-regulatory national policy framework designed to accelerate rapidly private sector deployment of advanced telecommunications and information technologies and services to all Americans by opening all telecommunications markets to competition . . . ." Joint Explanatory Statement of the Committee of Conference, H.R. Conf. Rep. No. 458, 104th Cong., 2d Sess. at 113 (Joint Explanatory Statement).

413 47 U.S.C. § 254(a), (d); *see also Universal Service NPRM*, 11 FCC Rcd 18092.